Robert Bates on Michael Kremer's "Incentives, Institutions, and Development Assistance"

This is an important paper, and for several reasons. The points fall into two categories: those having to do with methodology and those having to do with substance. The latter are so clearly communicated in the paper that there is little I can do to elucidate or amplify them. They stand as compelling ideas that should feature on the Agency's development agenda and I would lend whatever weight I can contribute to their advocacy. Less obvious, perhaps, are the points about method, and I devote myself to them.

Given Kremer's arguments in favor of field experiments, the justification for focusing on arguments over methods may seem odd. His argument in support of them is as transparent and powerful are his arguments for governance structures pertaining to debt, global public goods, and so forth. The reason I feel that matters of method require further discussion is that the proposals he develops themselves are the result of the use of a method – one that lies beneath the surface and that is itself not made explicit. My purpose is to bring it to the surface, for it is replicable and transportable and should be in the tool kit of development specialists.

The method is a form of reasoning, which takes several steps:

Step 1: Identify a problem. The word problem here has a very specific meaning. It means a situation in which there is a collective outcome that represents an equilibrium that is not efficient, i.e. socially rational.

Step 2: Assume (without need for defense) that people are rational. Assume as well (this will need defense) that the technology for correcting the problem is feasible and known.

Step 3: Steps 1 and 2 above, taken together, suggest that the problem arises from perverse incentives – i.e. incentives that make rational individuals make choices that are collectively irrational. The next step (Step 3) is thus to precisely characterize the source of the perverse incentives.

Step 4: The solution to the problem is then to posit an institution that would then generate the incentives that will lead rational individuals to choose in ways that yield as an equilibrium an outcome that is more efficient than that which generated the initial dilemma.

There are two ways of taking Step 3, and both are valuable. The first is to identify the class of problem that one has encountered. As I have argued elsewhere[1] there is a reliable mapping between forms of market failure and classes of strategic problems that yield perverse incentives and therefore result in socially inefficient outcomes. Production externalities, for example, imply property rights; and different forms of information asymmetries imply different forms of institutional remedies, depending on whether they give rise to problems of moral hazard to adverse selection. This mapping has the virtue of providing a check list that moves from class of problem to form of remedy that is crude but useful, perhaps, for those planning forms of public intervention.

A second way is less crude but, by the same token, more precise, and this is to map out the game that is leading rational players to behave in ways that undermine their collective well-being. This requires several types of knowledge. One is that of the historian or anthropologist, who has an in-depth, context rich understanding of the game being played: the preferences of the players, the information and expectations that they hold, the choices that they can make and the constraints that they face, and the sequence of interactions among them as they play out over time. Once deeply understood, the game can then be analyzed, formally – preferably – or informally – as in Kremer's paper and the behavior then understood as the equilibrium of the game. This Step 3 then leads seamlessly to Step 4, which involves the creation of a new structure – i.e. a new game – in which the choices of actors will, in equilibrium, lead to outcomes that are more desirable. This structure becomes an institution insofar as no one has an alternative unilaterally to alter their choices – i.e. it yields an equilibrium.

One reason that this approach is more demanding is that it involves thinking like a game theorist. But to some degree that is what the new institutionalism is all about: it is the application to economics of the theory of games rather than the theory of markets. Realization of the importance of market imperfection helped to create a demand for the production and use of game theory. The new institutionalism represents the form in which it has been supplied.

[1] "Institutions and Development," in The New Institutional Economics and Third World Development, ed. John Harriss, Janet Hunter and Colin M. Lewis (London: Routledge, 1995).